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Senate Fair Tax Study Committee

Presentation: Wesley Tharpe, Policy Analyst, Georgia Budget & Policy Institute

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Good morning. Thank you for that introduction, Mr. Chairman, and to you and all members of the committee let me offer my sincere thanks for the invitation to speak today.

My name is Wesley Tharpe and I'm the tax and economic policy analyst with the Georgia Budget and Policy Institute, which was founded in 2004 as a nonpartisan, nonprofit group devoted to building a more prosperous Georgia.

As many of you are likely aware, last month we published a report – of which I was the primary author and which was one of dozens of in-depth reports we publish on key issues each year – that laid out our case for why shifting from a balanced tax system that includes income taxes to one that relies wholly or mostly on sales taxes would not be in the best interests of Georgia.

Boiled down to its core, our view is that there are two overarching reasons Georgia should avoid proposals that seek to swap the state's income taxes for an expanded sales tax:

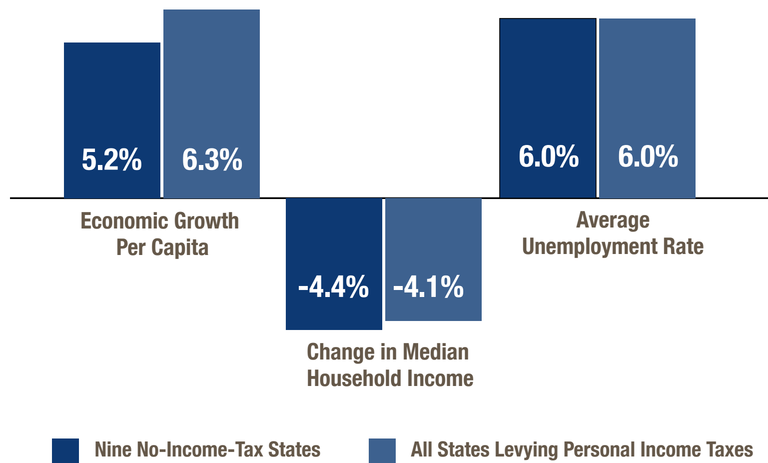
- One, the supposed economic benefits that some contend would result from deep income tax cuts are highly unlikely to materialize; and
- Two, enacting such sweeping tax changes would have a number of unintended consequences, such as pushing the cost of government down the income ladder onto families that are less able to pay.

Let me start by reviewing the first of these two points, or what I refer to as the "economic boon myth" – the contention that slashing income taxes is a proven recipe for boosting a state's economy. The reality is that despite their popularity and intuitive appeal, such claims are not supported by the vast majority of academic research or by the experience of other states. The assertion that economic evidence overwhelming supports the no-income-tax model rests on only a small handful of flawed studies whose findings have been somewhat cherry picked. Let me give one example:

Some have said that the nine states without income taxes (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming) had much stronger economies over the past decade than income-taxing states. But this claim overly relies on only a couple of measures that make no-income-tax states look superior, while ignoring a wide variety of other economic indicators where income-tax states perform just as well, if not better, than their no-income-tax peers.

For example, as shown in Figure 1 of your handout, income taxing states over the past decade had on average slightly stronger economic growth per person, smaller declines in household income and the same average unemployment rate as states without income-taxes. The comparison holds true even if you look only at the nine highest income tax states, which as of 2012, also have better wages, fewer residents without health insurance and more Fortune 500 companies on average than the nine no-income-tax states.

Figure 1



Source: Institute on Taxation and Economic Policy (ITEP)

These findings are consistent with the consensus of mainstream economics that lower state and local taxes are not reliably linked to stronger state economies. A recent comprehensive review of this question by the Center on Budget and Policy Priorities in Washington, D.C., determined that of 25 relevant academic studies and peer-reviewed articles published since 2000, only four found that state tax cuts consistently boost the economy. The other 21 found the impact of state and local taxes on economic growth to be either negligible, nonexistent or, in some cases, inconsistent – for example, where a particular tax might have an impact over one time span but not another, or where one tax might appear to matter in one state but matter not in another.

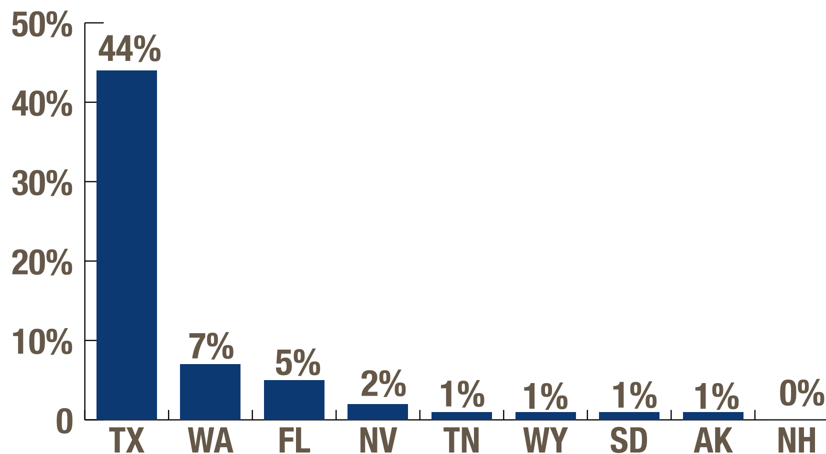
These findings are also consistent with the common sense reality that competitive tax levels are only one piece of the puzzle for state success. A state has a strong economy that creates jobs when its total package of attributes makes it an attractive place to start a business or raise a family. That means world-class schools and universities to educate workers and entrepreneurs; well-maintained roads and ports for businesses to get their goods to market; and high-quality communities with parks, libraries and other amenities. Sufficient tax revenue helps achieve these other attributes.

Now, a natural response to my argument might be "what about Texas? Doesn't their recent growth validate the no-income-tax model?" And it's true that the Texas economy has performed well over the past decade, just not due to the reasons some people believe. Much of Texas' growth in the 2000s is actually due in large part to two factors, neither of which are state and local taxes.

One, Texas' supplies of oil and natural gas put it a prime position to benefit from a natural resource boom over the past decade, which also boosted job growth in resource-rich states that do levy income taxes such as North Dakota. Two, due to some unique lending regulations in their state, Texas was able to mostly sidestep the meltdown of the housing market, which crippled states with as diverse tax regimes as Georgia, Florida and California.

In fact, the Texas story actually reinforces the point that there's nothing particularly special about no-income-tax states as a whole. A commonly cited statistic is that the nine no-income-tax states accounted for 62 percent of U.S. job growth during the 2000s. But as shown in Figure 2 of the handout, the reason that number is so high is because one of those nine states – Texas – accounted for 44 percent of U.S. job growth during that span. None of the other eight states came close to matching Texas' contribution, and five of the nine states without income taxes contributed 1 percent or less to the nation's net job growth in those years.

Figure 2



Source: Institute on Taxation and Economic Policy analysis of data from the Bureau of Labor Statistics

Let me make one last point on the economic front. Even if everything I just said was false, and it was the case that no-income-tax states have consistently stronger economies, it would still be true that many no-income-tax states have the luxury of certain unique assets unavailable to most states, including Georgia.

Three of the nine states – Alaska, Texas and Wyoming – gain enormous economic and revenue benefits from their abundant supplies of natural resources; about 80 percent of state revenue in Alaska, for example, comes from levies on oil and gas. Two of the nine – Florida and Nevada – have unique tourism markets that are heavily taxed to help replace their lack of income tax revenue. The other four – New Hampshire, South Dakota, Tennessee and Washington – are like Georgia, in that they lack these resources. They get by through heavy use of sales and property taxes and, in the case of Tennessee, by drastically underinvesting in key state priorities such as education and roads.

Put another way, even if the economic boon myth was true, Georgia can't drill Texas' oil, can't borrow Florida's beaches and doesn't want to be Tennessee. Even if we could emulate Texas, I'm not sure we would want to. The Lone Star state today ranks 49th in high school graduation, 10th highest on the share of its residents in poverty, dead last in the share of its residents with health insurance and tied for last with Mississippi for the percentage of its workers making at our below minimum wage.

The second major problem with a drastic shift from income to sales taxes is that such a move would have a number of specific drawbacks, which are well-documented from the experience of other states.

The most noteworthy is that a major tax swap would shift the cost government down the income ladder onto those least able to pay – lower and middle income families. In GBPI's recent report, we made some estimates of how extreme that shift might be, depending on how details of a final plan are filled in. We determined that any plan capable of being revenue neutral would likely raise taxes on a majority of Georgia households, while giving those at the very top of the income scale a significant tax break. We'll continue updating our estimates once more details about potential plans become available, and if later this year or next year there's a plan that we determine will cut taxes for most or all Georgians, we'll certainly report that.

What is important to understand, however, is that the technicalities of how state taxes work make crafting such a plan extremely hard. That's why other states exploring a tax swap haven't been able to crack the code of how not to raise taxes

on most families. Recently passed legislation in North Carolina, for instance, is scheduled to raise taxes on an estimated 80 percent of North Carolinians, or most households making less than $84,000 per year. In all, the top 5 percent of North Carolina taxpayers will receive 90 percent of the benefit from that final plan.

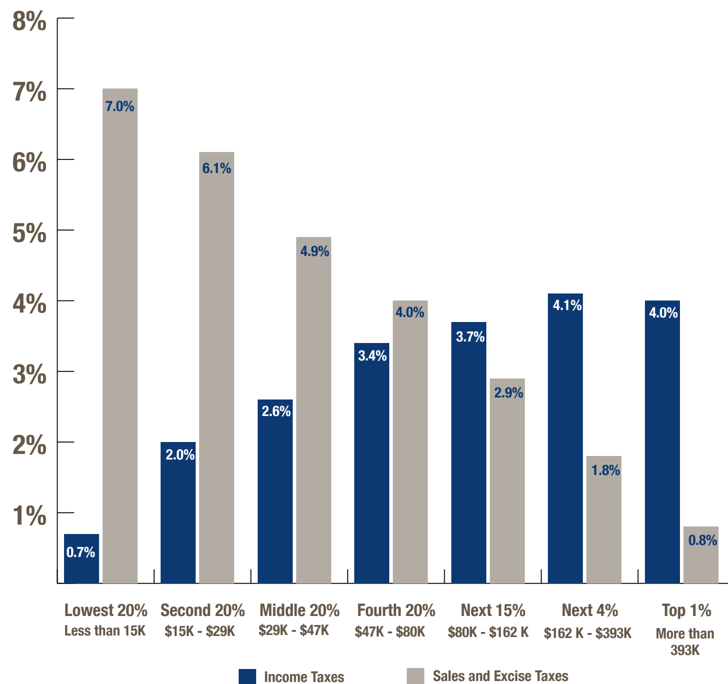
And North Carolina is not alone. A failed plan pushed by Gov. Jindal in Louisiana would have spiked taxes, on average, for 60 percent of that state's taxpayers, while also increasing the annual tax bill for Louisiana businesses by $500 million due to new taxes proposed on business to business services. Several states in the Midwest and Great Plains have flirted with the idea as well, such as Nebraska, where a proposal from that state's governor would have increased taxes by more than $700 a year for those making from $37-$60K a year, while dropping them by nearly $5,000 for taxpayers earning more than $91K a year.

Now, GBPI often gets the (perfectly reasonable) question of how do income tax cuts wind up raising taxes on many if not most families. It's because if you shift from income taxes to sales taxes, you increase state government's reliance on levies that already take a greater share from lower- and middle-income people. Working families have less annual income subject to income taxes than their wealthier peers, but they pay a greater share of their earnings on everyday needs such as clothes, school supplies and utilities.

Figure 3

Georgia's Income Taxes Fall More on Well-off, Sales Taxes Take More from Typical Families

State and local taxes as share of income, by income group



Source: Institute on Taxation and Economic Policy (ITEP)

As shown in Figure 3 of the handout, Georgians making less than $15,000 per year pay less than 1 percent of their annual earnings in personal income taxes but an estimated 7 percent of annual income in sales taxes. Georgians making from $162-$393,000, meanwhile, pay an estimated 4 percent of their yearly earnings in income taxes but less than 2 percent in sales taxes. This means if you shift even further toward sales taxes, many Georgia families would see only meager gains from income tax cuts, which for many would be cancelled out by drastically higher sales taxes.

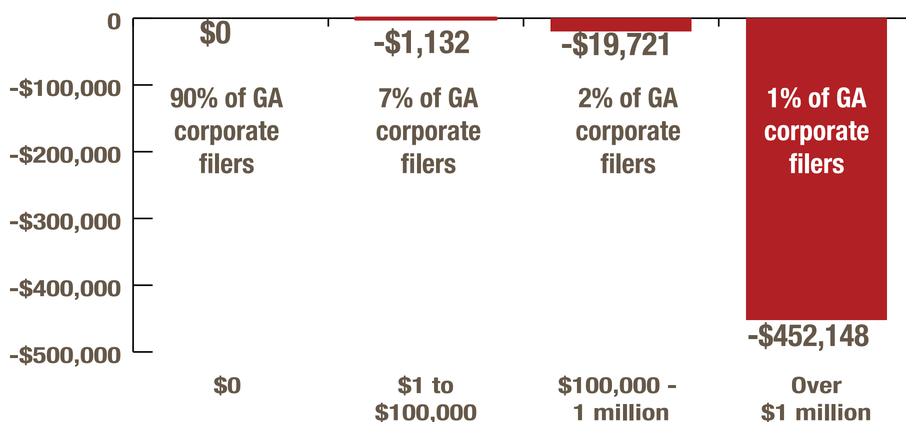
One response to this argument I just made is that can't any distributional problems be solved with a prebate or in other words some form of sales tax rebate? That may sound viable on paper, but in the real world it runs into a couple of very significant challenges. Most importantly, a prebate isn't free for the state – it would be tax revenue that lawmakers were choosing not to collect in order to protect certain taxpayers. That means it would have to be paid for in some other way. In our recent report, we concluded that a swap from income taxes to sales taxes could push Georgia's sales tax rate into the double-digits, and including a prebate could push the rate even higher. A prebate could also inadvertently shift taxes further onto the middle class, since families in the middle of the income distribution would not receive much benefit from most versions of a prebate.

That's the story on the personal income tax, but the idea of drastically reducing or eliminating Georgia's corporate income tax has also been floated in the past, including in a bill that was filed last session. However, few Georgia businesses would benefit from such a move, since most in-state companies don't actually have to pay the corporate income tax to begin with, due to the intricacies of how that tax works. In 2011, the most recent year of data available, 90 percent of businesses filing corporate returns in Georgia had no income tax liability at all. Most of the revenue from this tax in fact comes from less than 1 percent of corporate filers, who accounted for about 87 percent of the taxes paid in 2011. As shown in Figure 4 of the handout, eliminating Georgia's corporate income tax would give that 1 percent of corporate filers an average tax cut of nearly half a million dollars each, compared to small benefits at most for the rest.

Figure 4

Eliminating Georgia's Corporate Income Tax Would Only Benefit a Narrow Few

Average Tax Cut per Corporation, by taxable income group, 2011



Source: GBPI analysis of Department of Revenue data

Before closing, let me discuss one additional unintended consequence of a drastic tax shift from income to sales taxes. Based on evidence from other states, such a move could critically harm Georgia's state budget and, by extension, weaken lawmakers' ability to fund the public investments that businesses, families and Georgia's economy rely on.

The reality is that it is very difficult to make the math work on how to pay for a full or partial elimination of the state income tax, especially in the case of a state like Georgia where income tax revenue comprises roughly half of all state tax revenue. Under a tax shift plan, there are basically three ways that lawmakers could pay for deep income tax cuts: (1) drastically raise the sales tax rate; (2) drastically expand the sales tax base to include things not currently taxed, such as groceries and household or business services; or (3) assuming you leave the personal income tax partly in place, then drastically expanding the income tax base by capping or eliminating itemized deductions and ending various family and business credits, such as North Carolina recently did by eliminating its tax credit for film productions.

Although some of those choices, especially expanding the sales tax base to cover some personal services, could have merit within the context of comprehensive tax reform, they each face extreme hurdles to actually becoming law – as Georgia's tax reform experience in 2011 clearly illustrated. As a result, tax shift plans tend to result in a kind of double-edged sword where a state gets part of the distributional impact I discussed but also finds itself unable to pay the full cost of income tax cuts, resulting in a gaping hole in the state budget.

The recently enacted plan in North Carolina, for example, is scheduled to cut more than $650 million from the state budget, which adjusted for population, is roughly equivalent to cutting $700 million from Georgia's state budget. In Kansas, which has pursued the most aggressive version of the tax shift concept, a pair of tax bills passed in 2012 and 2013 will withdraw about $600 million per year from that state's budget, which would be equivalent to cutting about $2.1 billion from Georgia's budget. The Kansas cuts also led to a reduction in their credit rating for certain types of state bonds, and similar plans in Oklahoma and Missouri elicited warnings that declining revenues could potentially hurt their bond ratings as well.

In closing, let me say that thoughtful reform to modernize Georgia's tax code is a laudable and necessary goal. Georgia's income tax remains mostly unchanged from the 1930s, its sales tax remains mostly unchanged from the 1950s and its tax system as a whole raises less revenue per person than all but one other state, meaning it lacks the money necessary to invest in the foundations of a modern state economy, such as quality schools and world-class infrastructure. But plans that seek to merely swap income taxes for sales taxes are not comprehensive tax reform and would run counter to Georgia's most glaring need in the tax arena, which is to build a fairer, more balanced and more adequate system capable of collecting the money needed to invest in Georgia's future.

Thank you again for the invitation to speak, and I'm happy to answer any questions.